Foreign Exchange Market Inefficiency

And Exchange Rate Anomalies

Jing Li and Norman C. Miller

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Abstract

This paper develops a non-linear Uncovered Interest Parity, UIP, framework with FX market inefficiency that nests the non-linear econometric UIP models and the “infrequent portfolio adjustment” model of Bacchetta and van Wincoop. FX market inefficiency means that for any nonzero home minus foreign nominal interest differential, ID, there is always unexploited expected profit, which creates a tendency for a negative value for Fama’s beta coefficient. However, as ID decays over time, this tends to generate a positive value for Fama’s beta. The sign of beta is uncertain, depending on the relative values for the degree of FX market inefficiency and the rate of decay in ID. Simulations imply that the model is consistent with many exchange rate anomalies.

The authors are: Assistant Professor of Economics and Professor of Economics, Miami University, Oxford, OH 45056. Emails are: Li14@MUohio.edu and MillerNC@MUohio.edu.

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